CASH FLOW

Cash Flow

Cash flow is the net amount of cash and cash-equivalents moving into and out of a business. Positive cash flow indicates that a company's liquid assets are increasing, enabling it to settle debts, reinvest in its business, return money to shareholders, pay expenses and provide a buffer against future financial challenges. Negative cash flow indicates that a company's liquid assets are decreasing. Net cash flow is distinguished from net income, which includes accounts receivable and other items for which payment has not actually been received. Cash flow is used to assess the quality of a company's income, that is, how liquid it is, which can indicate whether the company is positioned to remain solvent.

The accrual accounting method allows companies to count their chickens before they hatch, so to speak, by considering credit as part of a company's income. "Accounts receivable" and "settlement due from customers" can appear as line items in the assets portion of a company's balance sheet, but these items do not represent completed transactions, for which payment has been received. They do not, therefore, count as cash. (Note that the credit vs. cash distinction is not the same as it is in everyday terminology; proceeds from credit card transactions are considered cash once they are transferred.)

The opposite can also be true. A company may be receiving massive inflows of cash, but only because it is selling off its long-term assets. A company that is selling itself for parts may be building up liquidity, but it is limiting its potential for growth in the long term, and perhaps setting itself up to fail. In the same vein, a company may be taking in cash by issuing bonds and taking on unsustainable levels of debt. For these reasons it is necessary to view a company's cash flow statement, balance sheet and income statement together.

Cash Flow Statement

There are three main financial statements: the balance sheet, income statement and cash flow statement. The balance sheet provides an overview of company assets and debts. The income statement provides an overview of company revenues and expenses. The cash flow statement bridges the gap between these two statements by showing analysts how much cash is generated or spent on operating, investing and financing activities.

Often called the "statement of cash flows," the cash flow statement indicates whether a company's income is languishing in the form of IOUs – not a sustainable situation in the long term – or is translating into cash flow. Even very profitable companies, as measured by their net incomes, can become insolvent if they do not have the cash and cash-equivalents to settle short-term liabilities. If a company's profit is tied up in accounts receivable, prepaid expenses and inventory, it may not have the liquidity to survive a downturn in its business or a

MAXIMUCH

lawsuit. Cash flow determines the quality of a company's income; if net cash flow is less than net income, that could be a cause for concern.

Cash flow statements are divided into three categories: **Operating Cash Flow, Investing Cash Flow** and **Financing Cash Flow**. Operating cash flows are those related to a company's operations, that is, its day-to-day business. Investing cash flows relate to its investments in businesses through acquisition; in long-term assets, such as towers for a telecom provider; and in securities. Financing cash flows relate to a company's investors and creditors: dividends paid to stockholders would be recorded here, as would cash proceeds from issuing bonds.

Free Cash Flow is defined as a company's operating cash flow minus capital expenditures. This is the money that can be used to pay dividends, buy back stock, pay off debt and expand the business. Below is a reproduction of Wal-Mart Stores Inc.'s Cash Flow Statement for the quarter ended April 30, 2015. All amounts are in million of U.S. dollars. Free cash flow expands on the attempt to avoid artificial deflation of a company's cash flow by adding the costs associated with one-time capital expenses, dividend payments and other non-reoccurring activity, as well as with other anomalous activity. This provides information about the amount of cash that was actually generated by the company during the time period being examined.

CASH FLOW

Cash flows from operating activities:	
Consolidated net income	3,283
(Income) loss from discontinued operations, net of income taxes	—
Income from continuing operations	3,283
Adjustments to reconcile consolidated net income to net cash provided by operating activities:	
Depreciation and amortization	2,319
Deferred income taxes	(159)
Other operating activities	239
Changes in certain assets and liabilities:	
Receivables, net	782
Inventories	(1,475)
Accounts payable	(319)
Accrued liabilities	(919)
Accrued income taxes	695
Net cash provided by operating activities	4,446
Cash flows from investing activities:	
Payments for property and equipment	(2,203)
Proceeds from the disposal of property and equipment	68
Other investing activities	22
Net cash used in investing activities	(2,113)
Cash flows from financing activities:	
Net change in short-term borrowings	(741)
Proceeds from issuance of long-term debt	43
Payments of long-term debt	(915)
Dividends paid	(1,579)
Purchase of Company stock	(280)
Dividends paid to non-controlling interest	(69)
Purchase of non-controlling interest	(70)
Other financing activities	(84)
Net cash used in financing activities	(3,695)
Effect of exchange rates on cash and cash equivalents	(14)
Net increase (decrease) in cash and cash equivalents	(1,376)
Cash and cash equivalents at beginning of year	9,135
Cash and cash equivalents at end of period	7,759

MAXIMUCH

Let's begin by seeing how the cash flow statement fits in with other components of Walmart's financials. The final line in the cash flow statement, "cash and cash equivalents at end of

period," is the same as "cash and cash equivalents," the first line under current assets in the balance sheet. The first number in the cash flow statement, "consolidated net income," is the same as "income from continuing operations" on the income statement.

Because the cash flow statement only counts liquid assets, it makes adjustments to operating income in order to arrive at the operating income that flows in as cash and cash equivalents. Depreciation and amortization appear on the balance sheet in order to give a realistic picture of the lifetime value of assets. Operating cash flows, however, are considered at face value, so these adjustments are reversed. Meanwhile assets that are not in cash form are deducted: inventories, for example. Investments that appear as assets on the balance sheet are deducted, because these were presumably paid for in cash. The statement also takes debt repayments, dividends and foreign exchange impacts into account. The main takeaway is that WalMart's cash flow was negative (a decrease of $1.38 billion) for this quarter, but that is not necessarily a bad thing as long as it retains sufficient reserves to handle short-term liabilities and fluctuations in its business.

A cash flow statement is a document that provides aggregate data regarding all cash inflows a company receives from its ongoing operations and external investment sources, as well as all cash outflows that pay for business activities and investments during a given quarter.

There are two forms of accounting: cash and accrual. Most public companies use accrual accounting, which means the income statement in the annual report is not the same as the company's cash position. For example, if a company lands a major contract, this contract is recognized as revenue, and therefore income, but the company may not receive cash until a later date. The accountant says the company is earning a profit on the income statement and paying income taxes on it, but the company may have less cash on hand. Even profitable companies can fail to adequately manage cash flow, which is why the cash flow statement is such a critical tool for analysts and investors.

The cash flow statement is split between three different **business activities**:

- Operations
- Investing
- Financing

Cash Flows From Operations (Operating Business Activities)

The first set of cash flow transactions is from operational business activities. Cash flows from operations starts with net income and then reconciles all noncash items to cash items within business operations. For example, accounts receivable is a noncash account. If accounts receivables go up, it means sales are up, but no cash was received at the time of sale. The cash

MAXIMUCH

flow statement deducts receivables from net income because it is not cash. Also included in cash flows from operations are accounts payable, depreciation, amortization and numerous prepaid items booked as revenue or expenses but with no associated cash flow.

Cash Flows From Investing (Investing Business Activities)

Cash flows from investing activities includes cash spent on property, plant and equipment. This is where analysts look to find changes in capital expenditures (CAPEX). While positive cash flows from investing activities is a good thing, investors prefer companies that generate cash flows primarily from business operations, not investing and financing activities.

Cash flow from investing activities is an item on the cash flow statement that reports the aggregate change in a company's cash position resulting from any gains (or losses) from investments in the financial markets and operating subsidiaries and changes resulting from amounts spent on investments in capital assets such as plant and equipment.

Cash flow from investing activities is an important aspect of growth and capital. Changes to **property, plant and equipment (PPE),** a large line item on the balance sheet, fall here. When analysts want to know how much a company is spending on PPE, they can look for the sources and uses of funds in the investing section of the cash flow statement.

Capital expenditures (capex), also found in this section of the cash flow statement, is a popular measure of **capital investment** used in the valuation of stocks. An increase in capital expenditures means the company is investing in future operations, however, it also points to a reduction in cash flow. Companies with high capital expenditures are generally in a state of growth.

Examples of negative cash flow from investing activities includes the purchase of fixed assets, the purchase of investment instruments such as stocks, and lending money. Examples of positive cash flow from investing includes the sale of fixed assets, the sale of investment instruments, and the collection of loans and insurance proceeds.

Cash Flows From Financing (Financing Business Activities)

A category in a company's cash flow statement that accounts for external activities that allow a firm to raise capital and repay investors, such as issuing cash dividends, adding or changing loans or issuing more stock. Cash flow from financing activities shows investors the company's financial strength. A company that frequently turns to new debt or equity for cash, for example, could have problems if the capital markets become less liquid.

MAXIMUCH

The formula for cash flow from financing activities is as follows:

Cash Received from Issuing Stock or Debt - Cash Paid as Dividends and Re-Acquisition of Debt/Stock

A positive number for cash flow from financing activities means more money is flowing into the company than flowing out, which increases the company's assets. Negative numbers can mean the company is servicing debt, but can also mean the company is retiring debt or making dividend payments and stock repurchases, which investors might be glad to see. Investors can also get information about cash flow from financing activities from the balance sheet's equity and long-term debt sections and possibly the footnotes. Cash flow from financing activities is one of the three main sections of a company's cash flow statement, the other two being cash flow from operations and cash flow from investing. This section of the cash flow statement measures the movement of cash between a firm and its owners and creditors.

Financing activities that generate positive cash flow include receiving cash from issuing stock and receiving cash from issuing bonds. Financing activities that generate negative cash flow include spending cash to repurchase previously issued stock, to pay down debt, to pay interest on debt and to pay dividends to shareholders.

Companies report cash flow from financing activities in their annual 10-K reports to shareholders. For example, a company might state that it repurchased 1 million shares at an average cost of $10 per share, that it paid out $5 million in shareholder dividends, that it used $2 million to pay off an older, higher-interest bond and that it received $2 million from issuing a new, lower-interest bond.

When analyzing a company's cash flow statement, it is important to consider each of the various sections which contribute to the overall change in cash position. In many cases, a firm may have negative overall cash flow for a given quarter, but if the company can generate positive cash flow from business operations, the negative overall cash flow may be a result of heavy investment expenditures, which is not necessarily a bad thing.

Non-Operating Cash Flows

Cash flows (inflows and outflows) that are not related to the day-to-day, ongoing operations of a business. Non-operating cash flows include borrowings, the issuance or purchase of stock, asset sales, dividend payments, and other investment activity. On most company balance sheets, total cash flows will be broken down into operating cash flows, investing cash flows, and financing cash flows, with the latter two making up non-operating cash flows.

MAXIMUCH

CASH FLOW

Investors will evaluate the cash flows along with revenues, profits and other operating metrics when researching individual companies. While the operating cash flows give a better indication of the long-term profitability potential of a company, the non-operating cash flows are also important to follow. These cash flows will shed light on how much it costs a company to raise capital (through debt and share offerings) and how well they manage the balance sheet through investing opportunities and asset sales.

Operating Cash Flow Ratio

The operating cash flow ratio is a measure of how well current liabilities are covered by the cash flow generated from a company's operations. The operating cash flow ratio can gauge a company's liquidity in the short term. Using cash flow as opposed to income is considered a cleaner, or more accurate, measure since earnings can be manipulated.

$$\text{OCF Ratio} = \frac{\text{Cash Flow from Operations}}{\text{Current Liabilities}}$$

There are essentially two worlds in fundamental investment analysis; one is based on cash, and the other is based on earnings. Good fundamental analysts use both when researching the value of an investment.

Earnings are derived from revenues. A company generates revenue, and then has to pay suppliers for the cost of goods sold and other expenses related to operations. It sounds simple, but there are many accounting conventions used to match revenues and expenses in the period they are incurred. It is a system referred to as accrual accounting. As a result, earnings may differ greatly from the actual cash flow of a company, and analysts like to use cash flow from operations as a cleaner proxy for profit than earnings or net income.

The Calculation and Interpretation

The operating cash flow ratio is calculated by dividing cash flow from operations (CFO) by current liabilities. Current liabilities are the portion of liabilities due within one year and can be found on the balance sheet. The operating cash flow ratio is a measure of the number of times a company can pay off current debts with cash generated in the same time period. A higher number means a company can cover its current debts more times, which is a good thing. Companies with a high or increasing operating cash flow ratio are in good financial health. Those that are struggling to cover liabilities may be in trouble, at least in the short term.

MAXIMUCH

CASH FLOW

Manipulation

Companies can also manipulate cash flow from operations; it is important to be mindful of a few accounting conventions. Some companies deduct depreciation expense from revenue even though it does not represent a real outflow of cash. Depreciation expense is an accounting convention which is meant to write off the value of assets over time, but it is not real cash. As a result, companies add depreciation back to cash in cash flow from operations.

Another way companies can manipulate cash flow is by paying bills later. If companies pay bills later, they can extend payables and the cash they have on hand. Likewise, if companies adopt looser credit policies, they may increase revenue and accounts receivable, which decreases cash. It may seem counter-intuitive that a company can grow revenues and show a decrease in operating cash flow, but this is how it happens and savvy analysts know where to look to find it.

Net Cash

Net cash is a company's total cash minus total liabilities when discussing financial statements. Net cash is commonly used in evaluating a company's cash flow, and can refer to the amount of cash remaining after a transaction has been completed once all charges and deductions related to the transaction have been subtracted.

Net cash may also be considered the short form when referring to net cash per share as it relates to stock investing. The term can be modified to distinguish the function of the funds, such as using net cash flow when describing incoming funds received over a particular amount of time. Investors can use net cash to help determine whether a company's stock offers an attractive investment opportunity, and may be used in conjunction with other measures to gauge the company's overall liquidity.

Net cash refers to the amount of liquid funds gained or lost due to the completion of a single transaction, or multiple transactions, after all obligations and liabilities are met. Obligations can include, but are not limited to, standard operating costs, payments on debts and investment activities. The calculating of net cash starts by determining the amount of receipts during a particular time, often referred to as the gross. Once totaled, all obligations paid from those funds are removed, leaving the net cash amount as the remainder.

Net cash flow refers to the gain or loss of funds over a period of time after all debts are paid. When a business has a surplus of cash after meeting all of the business' operating costs, it is referred to as having a positive cash flow. If the company is sending out more funds for

MAXIMUCH

obligations than it is earning through sales or other transactions, it is referred to as a negative cash flow.

A negative cash flow does not mean a company is unable to pay all of its obligations, only that the amount of cash brought into the company was not enough to cover the obligations for the same time period. If other savings vehicles are liquidated to meet the obligation, or additional debt is accrued that does not involve the receipt of a lump sum deposit, a company can meet all of its obligations while maintaining a negative cash flow.

Analysis of Net Cash

Most people associate positive events with increases in net cash, which can be examined to provide insight into a company's financial health. This can include profits made through the production of goods or providing of services as well as investment income. Certain activities may result in a positive cash flow that may not reflect positively on a company's financial health, such as money received as a result of incurring a new debt or activities associated with a lump-sum loan deposit.

Cash Flow Per Share

Cash flow per share is the after-tax earnings plus depreciation on a per-share basis that functions as a measure of a firm's financial strength. Many financial analysts place more emphasis on the cash-flow-per-share value than on earnings-per-share values. While an earnings-per-share value can be easily manipulated, cash flow per share is more difficult to alter, resulting in what may be a more accurate value of the strength and sustainability of a particular business model.

Calculated as a ratio, cash flow per share indicates the amount of cash a business has in its possession, based on a company's net income with the costs of depreciation and amortization added back in. Since the expenses related to depreciation and amortization are not actually losses paid with cash, reentering them into the calculation helps keep the company's cash flow from being artificially deflated. The calculation to determine cash flow per share is:

Cash Flow Per Share = (Operating Cash Flow – Preferred Dividends) / Common Shares Outstanding

Earnings per Share and Cash Flow per Share

A company's earnings per share is the portion of its profit that is allocated to each outstanding share of **common stock**, and like cash flow per share, serves as an indicator of a company's

MAXIMUCH

profitability. Earnings per share is calculated by dividing a company's profit, or net income, by the number of outstanding shares.

Since depreciation, amortization, one-time expenses and other irregular expenses may be removed from the company's net income, the outcome of this equation may be artificially deflated. Additionally, earnings per share may be artificially inflated when income from sources other than cash is added to the equation. Non-cash earnings can include sales in which the purchaser acquired the goods or services on credit issued through the selling company, and it can include the appreciation of any investments.

Since the cash flow per share takes into consideration a company's ability to generate cash, it is regarded by some analysts as a more accurate measure of a company's financial situation than the earnings per share metric. Cash flow per share represents the net cash a firm produces on a per-share basis.

Free Cash Flow To Sales

A ratio that illustrates the percentage of free cash flow to the amount of sales. The numerator is found by determining a company's free cash flow, which is available to debt and equity holders. The denominator is the company's annual sales.

Free cash flow is a ratio in and of itself and can indicate the "real" amount of cash that a company earns. This is because it is much more difficult to distort free cash flow with accounting gimmicks than it is to manipulate earnings. Therefore, the ratio of free cash flow to sales is a measure of how much of a company's revenue is transformed into cash.

MAXIMUCH